

**Rating Update: San Diego (City of) CA**

## **MOODY'S AFFIRMS RATINGS ON CITY OF SAN DIEGO, CALIFORNIA OBLIGATIONS**

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### **General Fund, Water and Wastewater Obligations Affected**

San Diego (City of) CA Sewer Enterprise  
Municipality  
CA

#### **Opinion**

NEW YORK, Feb 16, 2006 -- Moody's has affirmed the ratings on the City of San Diego's various general fund and enterprise obligations (listed below) and retained the negative outlook on those ratings. The ratings and outlook continue to reflect some uncertainty regarding the City's financial position, most significantly due to the lack of audited financial statements since fiscal 2002. Budget results and unaudited figures for recent years, however, lead us to believe that the city's financial stresses are manageable, though significant. Most recently, unaudited figures for fiscal 2005 indicate no significant change in the city's fiscal position since our most recent rating action (August 2005). The city's governance is currently undergoing a dramatic shift, providing an opportunity to re-focus financial management and priorities. The implications of that shift, however, remain to be seen and this uncertainty is also incorporated in the city's ratings. Solutions to the financial challenges faced by the city are not yet clear, much less implementation of specific steps to achieve structural balance. This situation is reflected in our continued negative outlook on the city's ratings. The local economy remains strong, however, and provides a reasonable foundation for the city's current ratings. Fundamentally, the city's general fund finances remain extremely narrow, with a tightly balanced budget and a weak balance sheet, both in terms of reserves and liquidity. By contrast the finances of the water and wastewater enterprises appear fairly sound. A significant additional consideration is that the wastewater system requires, and thus far appears to have maintained, access to the credit markets in order to fund critical capital improvements.

#### **GOVERNANCE CHANGES PROVIDE OPPORTUNITY TO ADDRESS SIGNIFICANT, LONG-TERM FINANCIAL CHALLENGES IN THE GENERAL FUND**

Pursuant to a voter-approved proposition, last month the city adopted a "Strong Mayor" form of government for a five-year trial period ending December 31, 2010. This significantly shifts power from the city's "legislative" branch to its executive branch. Under the new form of management the Mayor has veto power over nearly all resolutions and ordinances passed by the City Council except the Annual Appropriation Ordinance. Council override of the Mayor's veto would require five of eight votes. The first Mayor elected to serve under this system is the former Chief of Police who served the city through 1999. The Mayor has designed a new organizational structure and has filled the new position of Chief Financial Officer with an experienced California finance director.

Previously reported financial challenges facing the new team are unabated, notably the cost of numerous investigations in the short run and funding the city's pension liability over the long run. In fiscal 2005 the city experienced a small budget surplus deriving largely from the timing of revenues which outperformed expectations and offset excess expenditures. These modestly positive results were aided by the negotiated payment of less than the full actuarially required contribution to the pension system. The fiscal 2006 budget includes full payment of the actuarially required pension contribution assuming a 30-year amortization period. As of the first quarter of 2006 revenues again were somewhat ahead of budget, but expenditure increases have absorbed and exceeded these revenues. This has been driven in part by the costs of numerous investigations of city's prior financial and disclosure practices. Among those currently underway are inquiries by the SEC, U.S. Attorney's Office and FBI into the city's pension disclosure practices, and indictments by the district attorney of former and current pension system trustees on conflict-of-interest charges. [Please see our August 2, 2005 Rating Update for additional detail.] The investigations also pose a challenge in that as long as they continue the city's audited financials, from fiscal 2003 through the present, cannot be released.

The city has little room to maneuver within its general fund, as fiscal 2006 ending cash balances are projected to be very thin at 1% of receipts. Expenditure controls have been put in place for the current fiscal year, and for fiscal 2007 the independent budget analyst has recommended "no new funding", which should help rebuild some fiscal flexibility in the future. The mayor has asked council members to prioritize their budget requests, suggesting a more conservative funding environment than in the past. However, Moody's notes that despite the over \$1.37 billion deficit in the city's employee pension system--one of the key sources of its current difficulties--discussion of major expenditure cuts has not been in evidence. Securitizing the city's

tobacco settlement revenues has been suggested as a potential source of funding for the pension system, but this is more a solution in form than substance as it does not address the city's structural budgetary imbalance.

## WATER AND WASTEWATER SYSTEMS FINANCES REMAIN SATISFACTORY; PRIVATE PLACEMENT MARKET ENABLES NECESSARY WASTEWATER CAPITAL IMPROVEMENT PROJECTS

The city's water and wastewater systems appear financially stable. Unaudited financial results show healthy 1.6x debt service coverage of water bonds in fiscal 2004, and coverage of wastewater bonds improving from a slightly narrow 1.3x in fiscal 2003 (including a draw on the rate stabilization fund) to 1.47x in fiscal 2004. Management's reserve targets are being met for both systems, including 45-day operating reserves (\$26.4 million wastewater; \$16.3 million water), rate stabilization funds (\$37.8 million wastewater, \$20.5 million water), an emergency capital fund for the wastewater and water systems (\$5 million each) and a water purchase fund (\$6.4 million).

The wastewater system is addressing an important challenge revolving around access to the capital markets in order to fund critical components of its capital improvement program. In the absence of continued CIP funding, the city would be in danger of violating its regulatory obligations. Without audited financial statements, the system to date has had to rely upon comparatively short-term, interim, subordinate financing; this financing has been successfully restructured in order to defer principal amortization and extend final maturity (to 2007 and 2011, respectively) allowing the system time to find a longer term solution to its funding problem and in the process saving approximately \$45 million annually. The longer term solution is expected to take the form of a \$500 million private placement, approximately \$150 million of which will refund the interim financing and \$350 million provide funding for an additional two years of the system's capital improvement plan. The city issued a Request for Proposals for this financing and reports that the responses were very favorable. Accordingly, the prognosis is good for continued compliance with a settlement agreement negotiated with the Environmental Protection Agency and environmental groups.

## CITY'S ECONOMY REMAINS HEALTHY

The city's ratings derive in some measure from the size and resilience of its local economy. The city has recovered from the recession earlier in the decade. Taxable sales increased 5.0% in 2003 and 6.1% in 2004, a strong recovery from the less than 2% growth rate in each of the prior two years but still well below the rates experienced in the late 1990's. Assessed value (AV) citywide increased at a very rapid 11.6% in fiscal 2006, up from a strong 9.31% the prior year. Taxable AV (net of redevelopment) reached \$117.7 billion in fiscal 2005, the fifth consecutive year of year-over-year growth exceeding 8%. The resulting full value per capita of over \$90,000 epitomizes the recent wealth of city residents: this figure is about nearly 25% above the statewide median, and very strong by comparison with the 2000 census figure for per capita income which at \$23,609 represented only 104% of the statewide level.

## GENERAL FUND OBLIGATIONS:

Rated A3:

### GENERAL OBLIGATION BONDS

1994 - Open Space Park Refunding Bonds

1991 - Public Safety Communications Bonds

Rated Baa2:

### CERTIFICATES OF PARTICIPATION AND LEASE REVENUE BONDS

2003 - 1993 Balboa Park/Mission Bay Park Refunding

2003 - 1993 City/MTDB Lease Revenue Refunding Bonds

2002B - Fire and Life Safety Facilities Project

1998A - Convention Center Expansion

1996 A and B - Balboa Park/Mission Bay Park Capital Improvements and Refunding

1994 - City/MTDB Lease Revenue Refunding Bonds

Rated Baa3:

## CERTIFICATES OF PARTICIPATION AND LEASE REVENUE BONDS

1996A (Taxable) - Jack Murphy Stadium

### WATER REVENUE BONDS:

Rated A2:

Certificates of Undivided Interest in Installment Payments

Rated A3:

Subordinated Water Revenue Bonds, Series 2002.

### SEWER REVENUE BONDS:

Rated A3:

Series 1999A & 1999B

Series 1997

Series 1995

Series 1993

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